

86-925

No.

Supreme Court, U.S.
FILED

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IN THE
United States Supreme Court

FLORENCE Y. BARNES,

vs.

Petitioner,

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SEVENTH CIRCUIT

NO. 84-2605

PETITION FOR WRIT OF CERTIORARI

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1.

A.

QUESTION PRESENTED FOR REVIEW

Are payments to the widow
of a deceased University of
Illinois employee under State of
Illinois Survivors Insurance
Benefit Plan of the State Univer-
sities Retirement System life in-
surance payments and thus exempt
from income tax under Section 101
(a) (1) of the Internal Revenue
Code? [26 U.S.C., sec.101(a)
(1)]. (Abst. 20).

2.

B.

LISTING OF ALL PARTIES

The caption of the case lists
all parties.

3.

C.

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6.

D.

REFERENCE TO OFFICIAL REPORT

The decision in the District Court was not published, but is included in the Appendix herein (App. 7). The Seventh Circuit Court of Appeals decision is published and cited as 801 F.2d 984 (CCA 7, 1986) and is also included in the Appendix herein (App. 1).

7.

E.

JURISDICTIONAL GROUNDS

(1) Nature of Proceedings

This is an action instituted by petitioner in the United States District Court for the Central District of Illinois seeking a judgment for \$1706.94 plus interest against the United States of America for payment of taxes claimed to be erroneously or illegally collected from petitioner.

(2) Date of Judgment Sought to Be Reviewed

Judgment was rendered for petitioner and against respondent

by the District Court on March 27, 1985 (App. 7). Respondent appealed to the United States Circuit Court of Appeals for the Seventh Circuit which reversed the decision of the District Court on September 22, 1986 (App. 1).

(3) Statutory Provision Conferring Jurisdiction

Jurisdiction arises under the following statutes:

(a) 28 USC, Section 1346(a)
(1) granting jurisdiction to the United States District Court for the recovery of Internal Revenue taxes and interest erroneously and illegally assessed or collected from petitioner (App. 26).

(b) 28 USC, Section 1291
granting the Court of Appeals
jurisdiction of appeals from all
final decisions of the District
Courts of the United States (App.25).

(c) Rule 17 of the Supreme
Court providing for Petition for
Writ of Certiorari.

10.

F.

CONSTITUTION AND STATUTES INVOLVED

Since many of the statutes involved are lengthy texts, the references to the Illinois Constitution and all statutes are set forth verbatim in the Appendix.

Only the citations are set forth here.

11.

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G.

STATEMENT OF THE CASE

Petitioner Florence Y. Barnes is the widow of an employee of the University of Illinois at the Urbana-Champaign, Illinois campus who died August 23, 1970. Petitioner's husband as an employee of the university was subject at the date of his death to the provisions of the State Universities Retirement System ("Retirement System") as set forth in Ill.Rev.Stat., C.108½, Art.15 (1969) (App. 29,80). Upon her husband's death in 1970, petitioner began receiving a survivors insurance benefit of \$300 per

month totaling \$3,000 per year. She excluded these amounts from gross income as life insurance proceeds in her tax returns for 1978 and 1979. The Internal Revenue Service denied such amounts were excludable from income. It assessed deficiencies against plaintiff for taxes in the amounts of \$716 and \$743 for 1978 and 1979 respectively, plus interest due thereon. Petitioner paid the deficiencies, filed claims for refund and instituted this refund suit upon disallowance of her refund claims, pursuant to 28 USC, Section 1346(a) (1) (App.26).

Both petitioner and respondent filed motions for summary judgment. The motions were submitted to the District Court upon the exhibits (which were not controverted) attached to petitioner's amended complaint and the briefs and arguments of the parties.

The District Court entered summary judgment for petitioner in the amount of \$1706.94 and costs of suit and denied respondent's motion for summary judgment (App. 7).

Respondent appealed to the Seventh Circuit Court of Appeals

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which reversed the District Court
(App. 1).

Petitioner now submits her
Petition for Writ of Certiorari
to this Court.

H.

ARGUMENT

The issue before the Court is whether monies received as survivors insurance from the Retirement System are life insurance payments under Section 101(a)(1) and Section 101(d) of the Internal Revenue Code (26 USCA, Sections 101(a)(1) and (d) (App.20).

Although the amount involved in this suit is small, the adverse decision of the Seventh Circuit Court of Appeals has a tremendous financial effect on employees of the university system. As revealed in exhibits in support of petitioner's motion for summary judgment,

in 1978 (one of the tax years involved), there were more than 38,000 active participants subject to the Illinois Retirement System and contributing monies to provide survivors insurance. Because of the great number of taxpayers who are affected, there is justification for this Court to review the decision of the Seventh Circuit Court of Appeals.

The decision of the Seventh Circuit Court of Appeals in the case at bar held the survivors insurance was not life insurance, but a pension benefit that was

taxable income. This is contrary to the decision of the District Court and the decision of the Fifth Circuit Court of Appeals in Ross v. Odom, 401 F.2d 464 (CCA 5, 1968).

In Ross, on facts very similar to the case at bar, the Fifth Circuit Court of Appeals held that the survivors insurance benefits were life insurance benefits and thus not taxable income.

This Court would clarify this very important question by review of these different interpretations of similar statutes. It would also help clarify what is insurance

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within the meaning of the Internal
Revenue Code.

21.

I.

FACTS

Petitioner is the widow of an employee of the University of Illinois at the Urbana-Champaign, Illinois campus who died August 23, 1970. Petitioner's husband as an employee of the university was subject at the date of his death to the provisions of the State Universities Retirement System ("Retirement System") as set forth in Ill.Rev.Stat., C.108½, Art.15 (1969) (App. 29,79).

The general scheme of the Retirement System is two-fold:
(1) to provide retirement (and

disability) annuities for the benefit of the employee, and (2) to provide Survivors Insurance Benefits for the family of the employee (Affidavit of Actuary Barnes, paragraph 17-22 (App.84-86). The retirement annuity and survivor's insurance benefit are both financed on a contributory basis with each employee and the employer (University) sharing the cost. The employee's contribution to the cost of these two benefits was made by payroll deductions as follows:

(1) For his retirement annuity - 7%
Ill. Rev. Stat., C.108½
(1969), Sec.15-157(1)
and (6) (App. 73-76).

(2) For the survivor's insurance benefit - 1%.
Ill. Rev. Stat., C.108½,
Sec.15-158 (1969) (App.
77).

After her husband's death, petitioner received a Survivors Insurance Benefit of \$3,000 per year payable in monthly installments of \$250 (Ill. Rev. Stat., C.108½, Sec.
15-145 (1969) (App. 43).

Petitioner excluded from taxable income the \$3,000 survivors insurance benefit she received from the Retirement System in 1978 and 1979. The Internal Revenue Service assessed deficiencies on the grounds that the payments constituted "pension/annuity" payments and thus taxable as income.

Petitioner filed suit in the United States District Court for the Central District of Illinois, Danville Division, for refund. The District Court, on motion for summary judgment, found for petitioner and entered judgment against respondent.

The respondent appealed to the Seventh Circuit Court of Appeals which reversed the judgment of the District Court.

II.

SURVIVOR'S INSURANCE MEETS
REQUIREMENTS OF LIFE INSURANCE

Whether the payments received by the petitioner constitute "amounts received under an insurance contract" turns solely on whether there was in substance "a binding arrangement of risk-shifting and risk distribution" with respect to the Survivors Insurance Benefit provided by the Retirement System. Ross v. Odom, 401 F.2d 464, 467 (CCA 5, 1968) (emphasis added). This test prescribed in Odom was premised on long-standing principles firmly

established in the estate tax area by two leading cases cited and quoted by the Fifth Circuit - Helvering v. Le-Gierse, 312 U.S. 531, 539; 85 L.Ed. 996, 999 (1941) and Commissioner v. Treganowan, 183 F.2d 288, 291 (CCA 2, 1950), cert. denied 340 U.S. 853; 95 L.Ed. 625 (1950).

Petitioner suggests the reasoning of Ross v. Odom, 401 F.2d 464 (CCA 5, 1968) instead of the Seventh Circuit Court of Appeals decision in the case at bar should apply.

Until the Seventh Circuit Court of Appeals' decision, it was the only Court of Appeals decision to have considered the precise issue presented in this case.

In Odom, the plaintiff, widow of a deceased employee of the State of Georgia received payment of a Survivors Benefit under the Employment System of Georgia. Like the Illinois system, the Georgia system provided both (1) a retirement pension for the employee and (2) a Survivors Benefit for the protection of the family in the event of the employee's premature death.

Like Illinois, the Georgia system was a contributory system and the employee was subject to separately required payroll deductions for both his retirement pension and the Survivors Insurance.

In Odom, as in this case, the government claimed that the Survivors Benefit received by the surviving spouse did not constitute proceeds of a life insurance contract.

The Odom Court pointed to the fact that "approximately 20,000 other employees of the State of Georgia were also contributing an identical percentage of their monthly pay check into the one common Survivors Benefit fund.

The Court concluded: "The risk shifting requirement of an insurance arrangement was satisfied because the employee to the extent of

the prescribed benefits had effectively shifted the economic risk that could arise from his untimely death from his survivors to the fund." Id., p.468.

It followed, as the Court noted, that with over 20,000 employees and the employer (State of Georgia) contributing to the Survivors Benefit Fund, "the risk of loss that was shifted to the fund was in turn distributed to a large number of persons." Id. 468. This was deemed to meet "the risk distribution requirement historically imposed on any plan that aspired to be labelled life insurance."

Under the Illinois statutory plan in issue, there is a parallel of risk-shifting and risk distribution. As of August 31, 1978, there were more than 38,000 active participants (employees) subject to the provisions of the University Retirement System (Annual Report, p.14 submitted in support of motion for summary judgment). Thus, the petitioner's husband at the date of his death was sharing with a group of more than 38,000 the risk of his premature death inasmuch as each participating employee was required by statute to contribute 1% of his salary to finance the Survivors

31.

Insurance Benefit. Ill. Rev. Stat., C.

108½, sec. 15-158 (App. 77). Thus, the loss suffered by petitioner on her husband's death was shifted to fund. The risk of loss shifted to fund was in turn distributed to a large number of persons, including petitioner.

The normal cost of this benefit is fully funded (Affidavit of Actuary, ¶(24) and (25) (App. 89-90). In its audited Annual Report for year ended August 31, 1979 (copy submitted in support of petitioner's motion for summary judgment), the Retirement System reported that as of August 31, 1977, the balance of Accumulated Contributions for Survivors Insurance Benefits totaled \$89,377,286.

The full faith and credit of the State of Illinois was also

pledged to support the Survivors Insurance Benefit. Ill. Const., Art. 13, Sec. 5 (1970) (App. 19).

In Ross v. Odom, 401 F.2d 464, 468 (CCA 5, 1968), the Court emphasized that substance-not form-is controlling. The Court further stated at page 467 that to constitute life insurance, it is not necessary that "the agreement *** be in the form of the standard life insurance contract." Nor is it necessary "for a definite fund (specific assets) to be set aside." Id at 469, citing Haynes v. United States, 353 U.S. 81, 84; 1 L.Ed.2d 671, 674 (1957)

33.

III.

SEVENTH CIRCUIT DECISION
SHOULD BE REVERSED

The Seventh Circuit Court of Appeals failed to follow the reasoning of Odom. It first concluded that since the employee is guaranteed to get back all premiums he has paid into the plan, he has no risk under the plan.

There is, however, a fundamental fallacy in this position.

The Court erroneously concluded that the employee (insured) must bear the cost of the plan for there to be an insurance risk. But there can be an insurance risk even though the cost is borne entirely by a third party - for example, in those cases where the employer or some other source pays all the premiums. See Commissioner v. Treganowan, 183 F.2d 288 (CCA 2, 1959).

This leads to a consideration of a more fundamental error. The Seventh Circuit ignores the fact

that in the instant case, the Plan is a contributory plan and that the employer (State of Illinois) bears a substantial part of the cost. Under the Plan, both the employer (State of Illinois) and the employee share the risk and the State's contributions to the Plan are irrevocably committed to the payment of the benefits under the Plan. In no circumstances will either the State or the employee (or the employee's beneficiaries) receive a refund with respect to the State's contributions to the Plan.

To support its position that there is no risk shifting and

therefore no insurance, the Court relies on Edgar v. Commissioner, 48 TCM (P.H.), 79,524 (1979).

In Edgar, the payments to the widow were made solely from the employees' retirement annuity funds. There was no separate survivors life insurance benefit. For this reason, the Tax Court stated that Ross v. Odom, 401 F.2d 464 (CCA 5,1968) "is distinguishable". It noted that in Odom, plaintiff received payments not only from the employees retirement program (which was admittedly taxable), but also from the survivors benefit (life insurance) program (which were not taxable).

The Seventh Circuit also erroneously concludes that the fact that there is an interrelation between the pension benefits and survivors insurance benefits is fatal to the claim of life insurance. The Court felt the pooling of the contributions from the pension and insurance payments for investment purposes was fatal to the survivors insurance being life insurance.

Contribitions to the Illinois Retirement System are pooled to gain investment economies of size. This does not affect the financial integrity of each separate fund under generally accepted principles of accounting [Barnes Affidavit, ¶24 (App.89)].

The Seventh Circuit also improperly concluded that the restrictions placed on the right to receive benefit under the survivors

insurance program prevents the survivors insurance from being life insurance.

The Court of Appeals placed great reliance on Edgar v. Commissioner, 48 TCM (PH 79, 524, 1979); Davis v. U. S., 323 F.Supp. 858 (DCSD, W.Va., 1971); Lilly v. Commissioner, 45 TC 168 (1965). The death benefit under the Texas plan in Edgar was not separately funded. The payments in that case were made entirely from contributions to the employees retirement pension plan. For this reason, the Tax Court properly concluded that Ross v. Odom was not controlling. Similarly, the

death benefit payments under the West Virginia plan in Davis v. U. S. were made from the employees' retirement pension fund and did not therefore constitute life insurance payments from a separately funded insurance plan.

Lilly turned on the erroneous conclusion that Code Section 101 (b) (1) operated as a limitation upon the application of Section 101(a)(1) to preclude the exemption of life insurance proceeds provided under an employer plan upon the death of an employee. As pointed out in Ross v. Odom, 401 F.2d 464, 473 (CCA 5, 1968), this constituted a misreading of legislative history.

The Seventh Circuit Court erroneously felt that there is no insurance risk where the contract has no fixed return or where there is no guarantee that a sum certain will be paid upon the employee's death.

Commercial insurance contracts typically exclude coverage with respect to death by suicide or by reason of pre-existing conditions. Thus, to constitute life insurance, benefits need not be payable in all events. Further confirmation of

this point is illustrated by accidental death policies and the decision in Commissioner v. Noel's Estate, 380 U.S. 678; 14 L.ED.2d 159 (196

In Noel's Estate, the question was whether under the Federal Estate tax flight insurance payable only upon the accidental death of the insured constituted insurance "on the life of the decedent". This Court held it was life insurance, noting that Congress had not seen fit to distinguish life insurance and accident insurance.

In Estate of Connelly v. United States, 551 F.2d 545 (CCA 3, 1977),

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a group term life insurance contract was life insurance even though it provided for termination of payments if no eligible beneficiaries lived to receive them.

IV.

CONCLUSION

The issue petitioner requests this Court to resolve is whether survivors life insurance under the Illinois Retirement System is life insurance when payable on death in a certain manner.

There is no question the insured (petitioner's deceased husband) made monthly contributions to the survivors life insurance fund augmented by contributions on his behalf by the State. There is no question the insured died and that the

petitioner (his widow) is now receiving the benefits of the survivors life insurance.

The statutory program clearly shifted the risk of an insured's death from the decedent's estate to a fund created for over 38,000 participants. Further, the risk of loss which was shifted to the fund in turn will be distributed to a large number of persons.

Thus, the tests of risk shifting and risk distribution, the essential ingredients for life insurance, have been met.

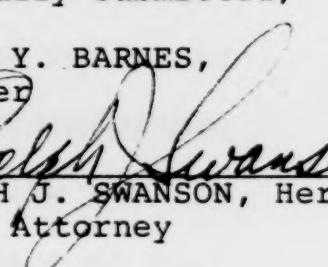
The differences in interpretation of similar statutes

by the Fifth Circuit Court of Appeals and Seventh Circuit Court of Appeals merits a resolution of this difference by this Court.

Respectfully submitted,

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